

Office of Chief Counsel
Internal Revenue Service

memorandum

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date: NOV 3 2000

to: North California Appeals Office
ATTN: Madeline Knoblauch, Appeals Officer

from: LMSB Practice Group, San Diego

subject: [REDACTED] - Application of I.R.C. §§ 162 and 482

On May 12, 2000, our office rendered advice on the audit team's proposed adjustments for both disallowing, pursuant to I.R.C. § 162, certain expenses paid by [REDACTED] (" [REDACTED]"), [REDACTED], and [REDACTED] (collectively the "[REDACTED]") to [REDACTED] and/or [REDACTED] and allocating, pursuant to I.R.C. § 482, income and deductions of the [REDACTED] between them and [REDACTED]. Since that time, our office has revised its position on the audit team's adjustments and communicated that position to Team Chief Marcia Hamm. You have requested that we put the position in a formal memorandum. This memorandum responds to that request.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work-product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for

closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether the Service may apply I.R.C. § 162 to disallow deductions taken by the [REDACTED] for royalty expenses paid to [REDACTED] and/or [REDACTED], as well as apply I.R.C. § 482 to distribute, apportion, or allocate income and deductions between the [REDACTED] and [REDACTED].

CONCLUSION

No. The position presented by the Service faces two problems. First, the Service has not provided sufficient information to determine how the parties arrived at the technical assistance fees and royalty fees or whether there is an interrelationship between these fees and the prices charged for the end product. As a consequence, the Service should not view the issue as one of disallowance but one of transfer pricing. Second, the Service must respect the terms of the agreements between the [REDACTED] entities, if the terms are consistent with the economic substance of the transaction. The Service has not provided any information or arguments for arguing that the terms are not consistent with the economic substance.

FACTS

I. PLAYERS

[REDACTED] is a [REDACTED] corporation engaged in the manufacture and sale of consumer [REDACTED] and [REDACTED]. [REDACTED] owns approximately [REDACTED] companies in [REDACTED] countries, [REDACTED] of which are found in the United States.

[REDACTED] is a Delaware corporation wholly owned by [REDACTED]. [REDACTED] manufactures [REDACTED] for sale to distributors, including [REDACTED] and [REDACTED] (USA) Corporation ("[REDACTED]"), a wholly owned subsidiary of [REDACTED].

[REDACTED] is a Delaware corporation wholly owned by [REDACTED]. [REDACTED] manufactures [REDACTED] for sale to [REDACTED] distributors, including [REDACTED] and [REDACTED].

██ is a Delaware corporation wholly owned by ██████████. ██████████ manufactures ██████████, and ██████████.

████████████████████ is a Delaware corporation wholly owned by ██████████. ██████████ distributes products manufactured by related entities within the United States.

II. TRANSACTIONS

A. Technical Assistance Agreements

████████, ██████████, and ██████████ each entered into technical assistance agreements with ██████████. Pursuant to the technical assistance agreements, ██████████ granted ██████████, ██████████, and ██████████ non-exclusive rights and licenses to use the "technical information" of ██████████ with respect to the manufacture of their products and to make use of any patents owned by ██████████ that were applicable to their products. The term "technical information" refers to drawings and specifications for the products, list of component parts, process specifications, performance specification, test data, lay-out of manufacturing facilities, and list of machinery and equipment. In exchange for the technical information, ██████████, ██████████, and ██████████ agreed to pay ██████████ a technical assistance fee based on the number of units manufactured and sold.

B. Other Royalty Agreements

████████, ██████████, and ██████████ entered into other royalty agreements in addition to the technical assistance agreements. These royalty agreements fall within one of the following three categories:

1. Contracts between ██████████ and ██████████, or ██████████ pursuant to which ██████████, ██████████, or ██████████ "reimbursed" ██████████ for lump sum payments made by ██████████ to an unrelated party to purchase a license to use that party's patents;
2. Contracts between ██████████ and ██████████, or ██████████ pursuant to which ██████████, ██████████, or ██████████ paid ██████████ a royalty comparable to the royalty that ██████████ paid an unrelated party for a license to use that party's patents; and
3. Contracts between ██████████ and an unrelated party that granted ██████████ a license to use that party's patents.

Generally, ██████████, ██████████, and ██████████ paid royalties to ██████████ based generally on the number of units sold.

III. ADJUSTMENTS PROPOSED BY EXAM

A. I.R.C. § 162

The Examination Division ("Exam") proposes to disallow the technical assistance fees and royalties paid by [REDACTED], [REDACTED] and [REDACTED] to [REDACTED] on the grounds that the expenses are not ordinary and necessary expenses incurred in carrying on the businesses of [REDACTED], [REDACTED], or [REDACTED], within the meaning of I.R.C. § 162.

Technical Assistance Fees

Exam bases its disallowance of the technical assistance fees primarily on the failure of the parties to adhere to the terms of the technical assistance agreements. Specifically, Exam states that [REDACTED], [REDACTED], and [REDACTED] were not expected to pay, and in fact did not pay, the technical assistance fees in years of poor profitability. As a consequence, Exam argues, the payments look more like dividends than fees for technical assistance.

Royalty Fee

Exam bases its disallowance of the royalties primarily on the failure of [REDACTED], [REDACTED], or [REDACTED] to prove that they incurred the royalties claimed. According to Exam, [REDACTED], [REDACTED], and [REDACTED] are basically assemblers of component parts. They do not manufacture the component parts that contain the technology covered by the patents licensed to [REDACTED] and, consequently, do not use the technology covered by the patents licensed to [REDACTED]. Therefore, they are not responsible for, and have not incurred, the royalty expense associated with those patents.

B. I.R.C. § 482

Exam also proposes to adjust, pursuant to I.R.C. § 482, the income of [REDACTED], [REDACTED], and [REDACTED] to reflect arm's length transfer prices. To determine the proper adjustment, Exam used the Comparable Profits Method ("CPM"), which compares the operating profits of controlled parties with those of uncontrolled comparables.

DISCUSSION

I.R.C. § 482 authorizes the Service to distribute, apportion, or allocate gross income, deductions, credits, and allowances between controlled entities, if it determines that such distribution, apportionment, or allocation is necessary to prevent evasion of taxes or to clearly reflect the income of any of such controlled entities. Stated differently, the Service may make

allocations among members of a controlled group if one member of the controlled group has not reported its true taxable income. Treas. Reg. § 1.482-1(a)(2).

In determining the true taxable income of a controlled taxpayer, the Service must take into account certain rules. Treas. Reg. § 1.482-1(f)(2). One such rule involves the aggregation of multiple transactions. Under this rule, the Service may consider the combined effect of two or more separate transactions if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Treas. Reg. § 1.482-1(f)(2)(i). Example 1 of Treasury Regulation § 1.482-1(f)(2)(i)(B) presents facts similar to those in this case. In that example,

P enters into a license agreement with S1, its subsidiary, that permits S1 to use a proprietary manufacturing process and to sell the output from this process throughout a specified region. S1 uses the manufacturing process and sells its output to S2, another subsidiary of P, which in turn resells the output to uncontrolled parties in the specified region.

Treas. Reg. § 1.482-1(f)(2)(i)(B) Ex. 1. The example concludes that "In evaluating the arm's length character of the royalty paid by S1 to P, it may be appropriate to consider the arm's length character of the transfer prices charged by S1 to S2 and the aggregate profits earned by S1 and S2 from the use of the manufacturing process and the sale of the products produced by S1 to uncontrolled parties." Id.

In this case, [REDACTED] licensed the [REDACTED] to use "technical information" necessary to manufacture [REDACTED]'s products and sold to the [REDACTED] the component parts to manufacture the products. The [REDACTED] sold their products to [REDACTED], as well as unrelated parties. In evaluating the arm's length character of the technical assistance fees paid by the [REDACTED] to [REDACTED], the Service should consider the arm's length character of the transfer prices for the component parts charged by [REDACTED] and the transfer prices for the products sold by the [REDACTED] to [REDACTED]. Conceivably, [REDACTED] may have charged the [REDACTED] less for the component parts than it would have had [REDACTED] not charged the [REDACTED] for the technical assistance fees. Similarly, the [REDACTED] may have charged [REDACTED] more for the products than they would have had the [REDACTED] not incurred the expense for technical assistance fees.

If we accept the premise of the possible interrelationship between the technical assistance fees and the prices for component parts, it is clear that the Service cannot simply disallow the technical assistance fees but that it must address the problem in terms of transfer pricing. That is, has [REDACTED] charged the [REDACTED] an arm's length price for the component parts? Has [REDACTED] charged the [REDACTED] an arm's length price for the technical assistance fees? At this point, the Service has not provided any information on how the parties arrived at the technical assistance/royalty fees or how the parties arrived at the prices charged for the component parts/products. Without an understanding of the interrelationship between the technical assistance/royalty fees, the Service should not disallow the expenses under I.R.C. § 162 but allocate the expenses, if necessary pursuant to I.R.C. § 482.

Another rule involves the treatment of contractual terms agreed to in writing by the parties. Under this rule, the Service must evaluate the results of a transaction as actually structured by the taxpayer unless the structure lacks economic substance. Treas. Reg. § 1.482-1(f)(2)(ii); see also Treas. Reg. § 1.482-1(d)(3)(ii)(B). In this case, the Service has not presented any arguments showing that the transactions between the [REDACTED] and [REDACTED] lacked economic substance. Therefore, Treasury Regulation § 1.482-1(f)(2)(ii) requires you to respect the transaction as structured. Accordingly, you may not disallow the transaction under I.R.C. § 162.

If you have any questions, please call the undersigned at (619) 557-6014.

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By: _____
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